Affirmative defenses
Equitable Liens
Equitable Subrogation
Resulting Trust

Paul Lansdowne, Inc., v Marko et al, Adversary No. 687-5025
(In re Cox), Consolidated Case Nos 684-08459, 08496-98

2/2/93 D. Ct. (J. Hogan) aff'd in part, rev'd in part and unpublished
Remanded decision by PSH

District court affirmed in part, reversed in part and remanded for adjustment of judgment originally awarding $118,291.55 to trustee as value of real property in turnover action under § 542, after offsets and improvements. By memorandum opinion dated 2/5/91 (E91-3((97)), Judge Higdon had determined that good faith improvers of rental property, who had purchased the property from parties who had acquired ownership via a forged quitclaim deed from debtors, were not entitled to imposition of a resulting trust in favor of the forger to 50% of the property. The District Court reversed, holding that because the bankruptcy court determined the forger put up half the purchase money with the debtor, he was entitled to a resulting trust by operation of state law (Calif.) And his half never became estate property. The District Court also held that no standing issue arose, and that the bankruptcy court's characterizing the resulting trust as an affirmative defense was unwarranted because "[i]n the context of this case, it is more accurately characterized as a matter of denial than of avoidance or affirmative defense." District Court further reversed an offset of $27,5000 "equitable lien" to defendants, representing increased value attributable to improvements, holding that this equitable remedy is not available when, as here, the good faith improvers' sole remedies were statutory under state law, albeit not applicable under the facts. The District Court affirmed the bankruptcy court's allowance, under principals of equitable subrogation, of offsets for encumbrances satisfied by defendants, and affirmed in all other respects.

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

In re	CV-92-6132-HO
S.D. COX INVESTMENTS, INC., STEVEN D. COX, DEBORAH M. COX, and EUGENE R. RICHMOND JR., Debtors.	Bankruptcy Court Case Nos. 684-08450-H7, 684-08496-H7, 684-08497-H7, 684-08498-H7
PAUL LANSDOWNE, INC., Trustee, Plaintiff-Appellant, vs. TAMARA MARKO, et al., Defendant-Appellees.	Adversary Proceeding No. 687-5025-H; OPINION

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75

HOGAN, Judge:

This bankruptcy matter involves conflicting claims to a parcel of real property. Record title to the property was once held by Steven Cox, a debtor in the underlying bankruptcies. The trustee, Paul Lansdowne, Inc. (plaintiff), brought an action for turnover of the property against, among others, defendants Ray and Linda Erta, its current record owners. After a trial, the bankruptcy court ruled for plaintiff, ordering the Ertas to pay a money judgment of approximately $118,000, reflecting the value of the property less setoffs. Both parties now appeal from certain of the bankruptcy court's rulings. For the reasons which follow, I affirm in part, reverse in part, and remand for adjustment of the judgment in accord with this opinion.

BACKGROUND

The property at issue is located at 416 Riverside Drive, Watsonville, California. It consists of three rental units on approximately 3/4 acres of land. Record title vested in the debtor Steven D. Cox with the recording, on February 28, 1983, of a grant deed from Barry J. Nottoli. Cox was then an investment broker and businessman in Medford, Oregon.

Nottoli had become the record owner of the property just seven weeks before the transfer to Cox, through a grant deed from Mary Tomasello recorded on January 6, 1983. At the time the Nottoli-to-Cox deed was recorded, the property was encumbered by two previously recorded deeds of trust: one from

Notolli to Tomasello for $87,500.00, and one from Notolli to NCI, Inc. for $2,000.00.

Cox managed the Watsonville property through Cox Property Management, a business he ran to manage his several real estate holdings. On September 24, 1984, however, Cox and his wife fled the Medford area as fugitives from justice, abandoning their businesses, which were then on the verge of collapse and under investigation by law enforcement agencies for securities violations. The Coxes' creditors successfully petitioned to have them declared involuntarily bankrupt. Cox remained hidden until December, 1988 when he was apprehended by the F.B.I. He later pled guilty to racketeering charges.

Promptly after the Coxes fled, James Cardinal, a Cox associate, began collecting rent from the Watsonville tenants. On October 3, 1984, Cardinal appeared before a California notary public with a quitclaim deed by which he claimed Steven and Deborah Cox had conveyed their interest in the Watsonville property to Tamara Marko, Cardinal's girlfriend. Cardinal declared before the notary that he had witnessed the Coxes execute and deliver the quitclaim deed on March 16, 1984. The notary notarized Cardinal's declaration and his acknowledgement of his own signature as witness. Cardinal had the deed recorded in the Santa Cruz County, California Recorder's Office.

Cardinal then listed the property for sale. He forged Marko's name to a listing contract with William A. Bergstrom,

Inc., a realtor, on October 31, 1984. A year later, on November 4, 1985, Ray Erta contracted to purchase the property for $150,000.00. At closing, Marko, paid from the purchase price a total of $99,208.45 to satisfy the two trust deeds and outstanding property taxes.

Ray and Linda Erta took possession on January 1, 1986. In March, 1987, the plaintiff trustee filed this adversary proceeding, naming the Ertas as defendants and claiming title to the property on behalf of the bankruptcy estates. Plaintiff sought to avoid the transfer of title to the Ertas on several theories, principally that the quitclaim deed to Marko was forged and thus void. The Ertas refused to surrender title and filed an answer asserting several defenses.

The case was tried before the bankruptcy court in Medford, Oregon between July 24 and August 4, 1989. A further evidentiary hearing was held on January 24, 1991 regarding the property's value. The bankruptcy court issued findings of fact and conclusions of law on February 5, 1991 (cited herein as Findings), and entered judgment for plaintiff on March 8, 1991. The court found that the Cox-to-Marko quitclaim deed had been forged, and that the subsequent transfer to the Ertas was void. The court directed the Ertas to pay plaintiff a money judgment for $118,291.55, representing the value of the property as of February 5, 1991 ($245,000.00), plus net rents received by the Ertas ($0), less a credit setoff for payment of encumbrances and property taxes ($99,208.45), and less a further "equitable

lien"/credit setoff for the increase in value to the property which the court found had resulted from the Erta's good faith improvements ($27,500.00).

Both parties appeal. The Ertas contend the bankruptcy court erred in rejecting their contention that the bankruptcy estate held title to 50% of the property subject to a resulting trust for the benefit of Cardinal. They contend such a trust should be recognized and the judgment reduced accordingly. The trustee alleges the bankruptcy court erred in allowing the increased value and encumbrance setoffs.

STANDARD OF REVIEW

"The district court acts as an appellate court, reviewing the bankruptcy court's findings of fact under the clearly erroneous standard and its conclusions of law de novo." In re Daniels-Head & Associates, 819 F.2d 914, 918 (9th Cir. 1987).

DISCUSSION

1. The Resulting Trust Contention

The bankruptcy court found that when Cox purchased the property from Nottoli, Cardinal contributed 50% of the down payment. Only Notolli, Cardinal, and Cox had been directly involved in the transfer. Each testified that Cardinal was to hold an equitable interest in the property. They differed, however, as to the extent of Cardinal's equitable interest. Notolli and Cardinal testified that the entire interest was to be held by Cox for Cardinal, while Cox testified that Cardinal was to own only a 50% interest.

The Ertas argue that because Cardinal contributed 50% of the down payment, and because Cox had himself intended that Cardinal owned half of the property, a purchase money resulting trust benefiting Cardinal arose by operation of law over half of the property. Consequently, they contend, the bankruptcy court erred as a matter of law in awarding plaintiff the entire equitable interest.

a. Relevant Procedural History

The Ertas first asserted their resulting trust defense in an amended answer filed on June 30, 1988. Plaintiff argued that the Ertas lacked standing to assert this defense, and the parties briefed that question to the bankruptcy court. To strengthen their position, the Ertas also moved for relief from the automatic stay to record a quitclaim deed from Cardinal (by which he purported to surrender to them all of his interest in the property). The bankruptcy court initially ruled for the defendants on the standing question, by a letter to counsel dated May 19, 1989. The court there noted that if the evidence at trial were to conflict as to

> Cox's ownership of the property before the purported transfer to Tamara Marko . . . [the court] will necessarily have to consider the various rights of the parties in the property, whether or not the [resulting trust defense] is raised . . . and [will] have discretionary power to impose an equitable trust if warranted under the facts . . . . Therefore, the issue of standing is moot and you may prepare for trial accordingly.

Supplemental Excerpt of Record, at 3 (emphasis added).

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In its initial post-trial Findings, the bankruptcy court reversed itself, ruling that defendants lacked standing to assert the resulting trust defense, because in doing so they rested on the legal rights of another (Cardinal). Findings at 58-59. The court also found that Cardinal had waived the resulting trust defense, which it considered an affirmative defense, by failing to plead it. Id. at 59. Even if the court could impose a trust on Cardinal's behalf, the court stated, it would decline to do so because his "conduct does not warrant such extraordinary equitable relief." Id. at 60.

The Ertas moved for amendment of the court's findings based on the court's failure to address the effect of the quitclaim deed from Cardinal to them. The court had never ruled on the Ertas' earlier motion for relief from the automatic stay to record that deed. The Ertas' post-trial motion to amend findings was denied from the bench on April 11, 1991. Excerpt of Record, X.[1] The court reasoned that the Ertas lacked standing to raise the resulting trust; that even if standing existed, the Ertas' position was no better then Cardinal's and the court would not, in the exercise of its discretion, impose a trust in favor of Cardinal due to his character and his methods of dealing with Steven Cox; that Cardinal had waived any right to assert a resulting trust by failing to plead it; and that the quitclaim deed from Cardinal

[1] The Excerpt of Record will be hereafter be cited as "Exc."

to the Ertas had itself violated the automatic stay, and was thus void or voidable. Id. pp. 9-17.

Defendants now contend (1) that the court erred in concluding they lacked standing to assert the resulting trust defense, and (2) that the court improperly considered Cardinal's worthiness of equitable relief, because a resulting trust arose by operation of law based on the fact of Cardinal's contribution to the purchase price of the property and the parties' intent that he take an equitable interest in it.

b. Standing

(1) Background

The bankruptcy court awarded plaintiff's judgment based on 11 U.S.C. § 542. Under § 542(a), the bankruptcy trustee is entitled to turnover of property that the trustee "may use, sell or lease under [11 U.S.C.] section 363." Section 363(b) entitles the trustee to use, sell or lease "property of the estate."[2] In seeking turnover, it is the trustee's burden initially to prove that the property in issue is "property of the estate." Yaquinto v. Greer, 81 Bankr. 870, 878 (Bankr. N.D. Tx. 1988).

Section 541 defines property of the estate. Under § 541(d), where the debtor possesses only a legal and not an equitable interest in property, the equitable interest does not

[2]Subsections f, g, and h of section 363 permit the trustee, under special circumstances, to sell more than the property of the estate. However, none of those circumstances obtains here.

become a part of the estate. Matter of Torrez, 63 Bankr. 751, 753 (9th Cir. BAP 1986), aff'd, 827 F.2d 1299 (9th Cir. 1987); In re Gurs, 34 Bankr. 755, 757 (9th Cir. BAP 1983). The Supreme Court has stated that "[c]ongress plainly excluded [from the bankruptcy estate] property of others held by the debtor in trust at the time of the filing of the petition." United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n.10 (1982).

The existence or nonexistence of a trust is determined by state law. Torrez, 63 Bankr. at 754. California law governs that question here, because California is the situs of the property at issue. Id.

(2) Was Standing At Issue?

The Ertas contend that under the facts as found by the bankruptcy court, a resulting trust in favor of Cardinal arose by operation of California law. Consequently, they contend, the estate lacked an equitable interest in the property -- and thus ownership -- beyond the extent of the 50% interest previously held by Cox for his own benefit. The Ertas argue that this lack of ownership on the estate's part is a missing element of the plaintiff's claim, rather than an affirmative defense upon which they bear the burden of proof. On this basis, they contend the resulting trust defense does not present a question of standing, because they were entitled to defend against plaintiff's claim regardless of standing.

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Plaintiff counters that under California law, a party seeking to enforce a resulting trust against the record title owner must plead and prove his entitlement to such a trust. In support, plaintiff cites Calistoga Civic Club v. City of Calistoga, 143 Cal. App. 3d 111, 191 Cal. Rptr. 571, 577 (1983). To defend against the estate's turnover claim, however, the Ertas need not necessarily prove their own entitlement to a trust, but rather merely that under state law, a trust existed, and thus that the estate did not own the property held in trust. It follows that to effectively rebut the Ertas' argument that no standing question arises, plaintiff must show that a resulting trust does not exist until enforced by its beneficiary. The Calistoga case does not support this proposition. The court stated there that

> A resulting trust is often called an 'intention enforcing' trust. It arises by implication of law ([citing former Cal. Civil Code] § 853)[fn] to enforce the inferred intent of the parties to a transaction.

191 Cal.Rptr. at 577 (emphasis added). In the footnote appended to this passage, the court noted

> [Former Cal. Civil Code] Section 853 provides that: 'When a transfer of real property is made to one person, and the consideration therefor is paid by or for another, a trust is presumed to result in favor of the person by or for whom such payment is made.'

Id. (quoting former Cal. Civil Code § 853, repealed, ch. 820, §§ 5, 43 1986 Cal. Stat. 439, 505) (emphasis in original). The Ninth Circuit has noted that the repeal of § 853 did not

disturb the California caselaw concerning trusts. In Re Torrez, 827 F.2d 1299, 1300 n.2 (9th Cir. 1987).

The bankruptcy court's opinion did not expressly respond to the Ertas' argument that no standing issue arose from the trust defense. Findings at 56-59. Rather, the bankruptcy court seems to have inferred that standing was at issue from its conclusion that the trust defense is an affirmative defense under Federal Rule 8(c). See id. at 59. As noted, the Ertas dispute the court's characterization of the trust defense as an affirmative defense. The only authority cited in support of that characterization is 5 Wright & Miller, FEDERAL PRACTICE AND PROCEDURE § 1270, at 411 (1990). That citation, however, constitutes no more than a restatement of the conclusion. The cited text only introduces the subject of affirmative defenses, without stating that any specific defense constitutes one. Moreover, neither the bankruptcy court nor plaintiff has cited authority for the proposition that assertion of an affirmative defense invariably raises a question of standing.

(3) Conclusion

I conclude that no standing issue arose. Characterizing the resulting trust as an affirmative defense was unwarranted. In the context of this case, it is more accurately characterized as a matter of denial than of avoidance or affirmative defense. See Fed. R. Civ. P. 8(b), (c). The trustee in a turnover action has the burden of establishing that the property at issue is property of the estate.

Yaquinto, 81 Bankr. at 878. Property of others held by the debtor in trust when a bankruptcy petition is filed is not property of the estate. Whiting Pools, 462 U.S. at 205 n.10. The estate's claim to ownership of the property in this case is based solely on the Nottoli-to-Cox transfer. If a resulting trust over 50% of the property arose by operation of California law from the circumstances of that transfer as found by the bankruptcy court, that portion of the property was not property of the estate. To that extent, the trustee would have failed to establish an element of its claim on which it bore the burden of proof, and would not be entitled to judgment.

c. Did a Trust Arise?

Under California law, when one party pays the purchase price for real property and places it in another's name, a resulting trust is presumed to arise. In re Torrez, 827 F.2d at 1300, n.2. Partial or pro tanto resulting trusts are also recognized. Martin v. Kehl, 145 Cal. App. 3d 228, 193 Cal. Rptr. 312, 318 (1983).

In Martin, plaintiff and defendant purchased a home together pursuant to an oral agreement under which each contributed 50 percent of the down payment. Title was placed in defendant's name, and defendant made the note payments in lieu of rent. When plaintiff sued to enforce the agreement, the trial court imposed a constructive trust for plaintiff's benefit. The Court of Appeal approved the constructive trust ruling, and further noted that a resulting trust arose,

yielding an alternative basis for affirmance. 193 Cal. Rptr. 317-18. Under the heading "A Resulting Trust Exists," the court noted that "[i]ndeed, this is a classic case of a resulting trust." Id.

Here, the bankruptcy court found that Cardinal and Cox had orally agreed to purchase the property as "50-50 partners" and to place legal title in Cox's name. Findings at 12. Cardinal contributed 50 percent of the purchase price. Id. at 12-13. He and Cox agreed that he would provide 50 percent of the expenses on the property, and Cardinal provided $10,000 toward those expenses prior to the bankruptcy filings. Id. at 12, 14.

The bankruptcy court ruled, however, that the Ertas' resulting trust defense could not succeed because their position was no better then Cardinal's and the court would not, in the exercise of its discretion, impose a trust in favor of Cardinal. The court based this refusal on Cardinal's actions vis a vis Cox and his conduct in this case. The court cited Cardinal's refusal to explain satisfactorily why the property had been placed in only Cox's name; his evasiveness and lack of credibility as a witness; his extraordinary, cash-based mode of transacting large business investments with Cox; and his failure to have counsel of record in this proceeding, despite the court's belief that he had consulted an attorney, and had in fact been clandestinely advised by one during telephone conferences. Exc. X, pp. 12-14.

Plaintiff contends the bankruptcy court's analysis can be affirmed based on either of two equitable defenses to the resulting trust: unclean hands or illegality (of the original Cox-Cardinal contract).

The unclean hands doctrine is

> rooted in the historical concept of [the] court of equity [serving] as a vehicle for affirmatively enforcing the requirements of conscience and good faith. This presupposes a refusal to be 'the abetter of iniquity.'

11 Witkin, Summary of California Law, Equity § 8, p. 684 (9th Ed. 1990) (quoting Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co., 324 U.S. 806 (1945)).

Here, plaintiff cites Cardinal's fraud in forging the Cox-to-Marko deed and absconding with the proceeds as having tainted Cardinal with unclean hands. The Ertas are in turn tainted also, plaintiff argues, by virtue of their standing in Cardinal's shoes. Thus, plaintiff contends, the resulting trust -- a creature of equity -- ought not be invoked for their benefit.

Holding the Ertas accountable for Cardinal's conduct, however, would cause the bankruptcy estate to be unjustly enriched at their expense. If the trust is not recognized, the estate recovers all of the property, although the debtor -- by his own account -- never owned more than half of it. As a further consequence, the Ertas, having once paid Cardinal full value, would be required to pay a second time, in a money judgment based (again) on the property's full value.

If the trust is upheld, by contrast, the estate's recovery is limited to the debtor's 50% interest. The Ertas still obtain only two-thirds of value. They paid Cardinal full value, yet subsequently become liable to the trustee for the estate's 50% interest.

Neither the bankruptcy court nor the parties have cited authority directly addressing the question of whether the Ertas should be held accountable for Cardinal's inequitable conduct. It is not contended, however, that the Ertas share any actual culpability with Cardinal. It is merely argued that the Ertas should stand in Cardinal's shoes because their rights derive from his. I disagree. Given the actual equities between the parties before the court, refusing to recognize the trust would be inconsistent with the unclean hands doctrine in that it would facilitate the unjust enrichment of the bankruptcy estate at the expense of an innocent party. It would also be inconsistent with another equitable maxim, that disfavoring the elevation of form over substance. See Witkin, supra, at §4, p. 682 ("Equity looks at substance rather than form").

Plaintiff next contends the original Cox/Cardinal contract should not be enforced in equity due to its illegality. In the Torrez case, the Ninth Circuit rejected this defense in a similar context. There, debtor had taken title to 120 acres of farm land purchased by the defendant, giving rise to a resulting trust in defendant's favor. Title had been taken in debtor's name for the sole purpose of

enabling defendant to violate statutory limits on allotments of federally subsidized irrigation water. Debtor later undertook to sell the property to finance its own reorganization, contending that the resulting trust was void due to its illegal purpose.

In rejecting the illegality defense in Torrez, the court considered the following factors, which govern whether judicial recognition is afforded to illegal agreements under California law:

> [1] The completed nature of the transaction, such that the public can no longer be protected by invocation of the rule that illegal agreements are not to be enforced;
>
> [2] the absence of serious moral turpitude on the part of the party against whom the defense is asserted;
>
> [3] the likelihood that invocation of the rule will permit the party asserting the illegality to be unjustly enriched at the expense of the other party; and
>
> [4] disproportionality of forfeiture as weighed against the nature of the illegality.

827 F.2d at 1299.

Here, plaintiff characterizes the agreement giving rise to the trust as illegal by associating it with the unsavory conduct of Cardinal as noticed by the bankruptcy court, i.e. his cash-based, secretive business dealings and his invocation of the fifth amendment in refusing to answer questions. Unlike Torrez, there was no actual finding that the Cox-Cardinal agreement was illegal. Even if it is presumed to be illegal,

however, application of the Torrez factors militates against refusing to recognize the resulting trust.

First, even if the Cox-Cardinal agreement's purpose was to frustrate federal law (such as by evading taxation), it is not substantially different than the illegal agreement in Torrez, which was enforced. Both cases involved frauds against the government, but neither involved threats to human life or health. Second, the Ertas, against whom the illegality defense is now asserted, were not found to have engaged in immoral or inequitable conduct. Even Cardinal acted without greater moral turpitude than the corresponding party in Torrez, in so far as the agreement to conceal his interest in the property is concerned. Third, refusal to uphold the trust would, as discussed previously, unjustly enrich the bankruptcy estate at the Ertas' expense. This unjust enrichment factor was that which the Torrez court found "most compelling" in its analysis. 827 F.2d at 1301-02. Finally, forfeiture is disproportionate to the nature of the illegality, which has not even been determined.

Plaintiff also argues that the Ertas did not satisfy their burden of proof in establishing the resulting trust. The party asserting a pro tanto resulting trust must establish with definiteness and specificity the proportional amount contributed. Loyds Bank California v. Wells Fargo Bank, 187 Cal. App. 3d 1038, 232 Cal. Rptr. 339, 342 (1986), rev. denied (1987). The trust's existence must be proven by clear and

convincing evidence. Carr v. Yokohama Specie Bank, Limited, 99 F. Supp. 4, 7 (N.D. Cal. 1951), aff'd, 200 F.2d 251 (9th Cir. 1952).

In arguing that the Ertas failed to satisfy these standards, plaintiff relies primarily on the discrepancies between Cox's testimony (that he and Cardinal were 50-50 partners) and that of Cardinal and Nottoli (that Cox held all of the property for Cardinal). The bankruptcy court resolved that conflict completely in Cox's favor, finding his testimony credible and unbiased. There was no dispute as to whether a trust existed, and no evidence that the trust covered less than 50 per cent of the property. The earlier evidentiary conflict over whether the trust extended to a greater portion of the property does not undermine the Ertas' establishment of the pro tanto trust.

Plaintiff finally argues that the trust is subject to avoidance under the bankruptcy code in any event. Plaintiff first asserts a theory based on § 544 and the hypothetical premise that the estate took title to the property as a bona fide purchaser. Under California law, a resulting trust can be defeated by a bona fide purchaser without notice of the trust interest. Matter of Torrez, 63 Bankr. at 754 (citing Cal. Civ. Code § 856). Possession by another, however, constitutes constructive notice of the rights of the person in possession, precluding a bona fide purchaser from claiming it took without notice. Id. Here, the bankruptcy court found that Cardinal

had begun collecting rent from the tenants on the property prior to October 18, 1984, the date the bankruptcy petitions were filed. See Findings at 22 (Cardinal began collecting rent on October 4, 1984). This would constitute constructive notice to the trustee of Cardinal's interest in the property, and thus preclude its taking title as a bona fide purchaser and thus avoiding the resulting trust. See Matter of Torrez, 63 Bankr. at 754 (debtors were not bona fide purchasers where trust beneficiary farmed the land and their farmhand lived on it).

Plaintiff next asserts a theory based on § 547. Plaintiff argues that even if the trustee did not have bona fide purchaser status, Cardinal's interest in the property was not perfected until he began collecting rents, within the 90 day preference period preceding the bankruptcy filing. Section 547, however, allows the trustee to avoid a "transfer" made within the preference period. 11 U.S.C. § 547(b)(2). There was no transfer within that period here. To the extent Cardinal has an interest, it had existed since the original Nottoli-to-Cox/Cardinal sale.

I reverse the bankruptcy court on the resulting trust question. I conclude that no standing issue was presented and that a resulting trust in favor of Cardinal over a 50 % interest arose from the facts of the original Notolli-to-Cox transfer by operation of California law. Because the debtor had not owned the 50 % equitable interest he held for Cardinal, that interest was not property of the estate. The bankruptcy

court erred in entering judgment based on the full value of the property.

2. Offset for Value of Defendants' Improvements

Plaintiff attacks as legal error the bankruptcy court's allowance to defendants of a $27,500 offset representing the increase in the property's value which the court attributed to defendants' improvements.

(1) Procedural Background

The bankruptcy court initially denied defendants' claim to an equitable lien against the property in an amount reflecting the value of the improvements. Findings at 60-63. The court reasoned that California's "good faith improver" statutes provide the exclusive remedy where the value of improvements is sought by a holder of property who acted in good faith. Id. at 61. The court then went on to allow defendants a setoff for the increased value under Cal. Code of Civ. Proc. § 741, one of the good faith improver statutes. Findings at 63-74; 34-37. Section 741 provides for such setoffs, under certain circumstances, against damages awarded for the defendant's wrongful withholding of property.

In its letter opinion denying plaintiff's post-trial motions, the court concluded it had erred in applying § 741. Section 741 only allows setoff against a damages award. Because the court had awarded plaintiff only the value of the property, and no damages for withholding, it concluded § 741 was inapplicable. Exc. Y at 1. The bankruptcy court did not

disturb its result, however. The court reevaluated and reversed its earlier conclusion that the statutory remedies for good faith improvers are exclusive, and found that defendants were entitled to an equitable lien against the property in the same amount as the original $ 741 setoff. Id. at 2-5.

(2) Exclusivity of Statutory Remedies

Plaintiff contends the court erred in reversing its earlier ruling on the exclusivity of statutory remedies. California courts have long held that the state's good faith improver statutes preclude resort to general equitable principles to grant good faith improvers remedies that are not available by statute. See, e.g. Trower v. Rentsch, 94 Cal. App. 168, 270 P. 749, 750 (1928) (equitable lien cannot be imposed based on general equitable principles "when contrary to the provisions of a positive statute."); see also, Taliaferro v. Colasso, 139 Cal. App. 2d 903, 294 P.2d 774 (1954). In this case, however, the bankruptcy court concluded that "a California court would impress an equitable lien in favor of an improver" if no statutory remedy was applicable. Exc. Y at 2. In support, the court cited Jones v. Sacramento Savings and Loan Ass'n, 248 Cal. App. 522, 56 Cal. Rptr. 741 (1967). Id.

The Jones court granted an equitable lien against a residential subdivision in favor of a construction lender. The construction lender mistakenly believed its lien had priority over that of the (senior) purchase money lender. The borrower/developer defaulted on both loans, and each lender

foreclosed. A quiet title action ensued in which the lenders disputed priority. The court rejected the construction lender's claim, but noted that unless an equitable lien were imposed in its favor, the purchase money lender would be unjustly enriched, because the value of the construction loan-financed improvements far exceeded that of the land.

The Jones court invoked a general equitable doctrine providing for "imposition of an equitable lien where the claimant's expenditure has benefitted another's property under circumstances entitling the claimant to restitution." 56 Cal. Rptr. at 746. In its letter opinion, the bankruptcy court invoked the same principle to impose a lien in favor of defendants here. Exc. Y, at 2-3.

Jones, however, is not inconsistent with the rule that good faith improvers must look to the statutes for their remedies. It is not a good faith improver case. As the Jones court itself noted in rejecting assertion of the exclusive remedy rule, the good faith improver statutes apply to

> one who makes improvements while 'holding' the land, not to one who has supplied services to its acknowledged owner or lent him money in reliance upon a security instrument.

56 Cal. Rptr. at 748.

In rejecting plaintiff's assertion of the exclusivity rule, the court also suggested another rationale on which its ruling might be sustained. The court found plaintiff's reliance on the Taliaferro case misplaced because that case had

been decided before the enactment of Cal. Civ. Proc. Code § 871. Exc. Y at 4. Section 871 is another good faith improver statute. Taliaferro applied the exclusivity rule to conclude that an offset could not be granted on general equitable principles where there were no damages to be setoff, and thus no available right to setoff under section 741. Unlike § 741 and Taliaferro, however, the later-enacted § 871 authorizes granting relief to good faith improvers even in the absence of a damages award, where the good faith improver asserts an affirmative claim or counterclaim under § 871. Id. (citing California Law Revision Commission Comment to Section 871.1 (1968)). Such claims are subject to a one year statute of limitations. Cal. Civ. Proc. Code § 340(5).

It does not follow from the fact that Taliaferro was decided prior to the adoption of § 871 that California's good faith improver statutes no longer provide improvers their exclusive remedies. Rather, that sequence indicates only that statutory relief that was not available when Taliaferro was decided is now available under § 871.

(2) Section 871 Statutory Relief

Defendants suggest the offset could be sustained based on § 871. I disagree. Defendants did not plead a § 871 counterclaim below, and neither of their alternative arguments for avoiding the one year statute of limitations is persuasive. They first suggest that the limitations statute should not be applied to a counterclaim asserted solely for purposes of

setoff. Response at 37-38 (citing Minelian v. Manzella, 215 Cal. App. 3d 457, 263 Cal. Rptr. 597 (1989)). The doctrine of setoff, however, is equitable in nature. A § 871 counterclaim, by contrast, is legal in nature; it is based on a special statute and subject to a specific limitations period.

Defendants next suggest that a § 871 claim was implied in the good faith improver affirmative defense they pled. That defense, however, asserted only a right "to set off against any damages;" it cannot reasonably be read as implying an affirmative § 871 counterclaim. Exc. B, para. 52, at 8. Further, to construe it as such would be prejudicial to the plaintiff, as both parties proceeded at trial on the understanding the defense was premised on § 741, without addressing the procedures and standards which govern a § 871 claim.

I reverse the bankruptcy court's ruling awarding an offset to defendants for the value of their improvements to the property. The court erred in imposing an equitable lien. California law limits good faith improvers to their statutory remedies. Defendants were not entitled to relief under Cal. Code Civ. Proc. § 741, and failed to assert a timely counterclaim under § 871.

b. Setoff for Pre-Existing Encumbrances

Plaintiff next attacks as legal error the allowance to defendants of a $99,208.45 offset representing the amounts paid at closing to satisfy existing encumbrances on the property.

(1) The Bankruptcy Court's Analysis

The bankruptcy court allowed this offset based on its conclusion that the Ertas' purchase money lender, Watsonville Federal Savings and Loan (Watsonville Federal), was entitled to equitable subrogation. Under the doctrine of equitable subrogation, a special status is afforded to one who pays off an encumbrance on realty at the instance of the owner of the property or the holder of the encumbrance based on an understanding that the money advanced will be secured by a first lien on the property. If the new security is later revealed to not be the first lien on the property, its holder, if not chargeable with culpability or inexcusable neglect, will be subrogated to the rights of the prior encumbrancer under the security it holds. Katsivalis v. Serrano Reconveyance Co., 70 Cal. App. 3d 200, 138 Cal. Rptr. 620, 625 (1977). The lender who advanced the funds is viewed, in equity, as the assignee of the prior encumbrance, in consideration of the money advanced. Id. (citing Swift v. Kraemer, 13 Cal. 526, 530 (1858)).

Here, the bankruptcy court found Watsonville Federal was entitled to the benefit of equitable subrogation based on its having provided the Ertas the financing to pay off the encumbrances on the property at closing. The Ertas were to be listed on the title as the owners, and they agreed with Watsonville Federal that it would have a first lien on the property upon release of the prior encumbrances. Findings at 76.

The court rejected plaintiffs' contention that Watsonville Federal was chargeable with culpable and inexcusable neglect. To the contrary, the court found,

> Watsonville [Federal] followed its standard operating procedure in processing this loan application; . . . [it] had no contact with Bergstrom about this property; . . . [it] had no knowledge of any ownership interest Cardinal may have claimed . . . ; . . . [it] did not know Tamara Marko; . . . [it] had no discussions with Ray and Linda Erta about the prior ownership of the property; . . . did not review the chain of title . . .; and . . . [it] had no actual knowledge of the Cox claim to the property until served with the complaint in this lawsuit.

Id. at 77. Having found their lender entitled to equitable subrogation, the court concluded that if the Ertas retained the property, their liability should be reduced to reflect the payment of the encumbrances, as those amounts inured to the benefit of the estate. Findings at 78.

(2) Was Equitable Subrogation Properly Allowed?

Plaintiff first contends the subrogation doctrine was inapplicable because the true owner of the property, Cox or his bankruptcy trustee, was not involved in obtaining the financing from Watsonville Federal. This argument is unpersuasive. While it factually distinguishes Katsivalis, it does not undermine the availability of subrogation. The Watsonville property was encumbered to the extent of the offset prior to (and wholly apart from) the fraudulent transfer to Marko. Watsonville Federal's satisfaction of the encumbrances therefore benefitted the bankrupt estate.

The essential rationale of the equitable subrogation doctrine in this context is that equity

> "[will] not permit [the estate] to take [Watsonville Federal's] money and apply it in extinguishment of a prior incumbrance, and then claim that the property should neither be bound by the new mortgage nor the old."

Katsivalis, 138 Cal. Rptr. at 625 (quoting Swift, supra, 13 Cal. at 530). It is in these circumstances that equity considers "'the substance of the transaction [to] be an assignment of the old mortgages in consideration of the money advanced.'" Id.

That the encumbrances pre-existed the void transfer also distinguishes this case from those cited by plaintiff for the proposition that encumbrancers are not entitled to relief where they lend on a forged or otherwise void deed. See e.g. Bryce v. O'Brien, 5 Cal.2d 615, 55 P.2d 488 (1936); Trout v. Taylor, 220 Cal. 652, 32 P.2d 968 (1934).

Plaintiff further argues this case should be governed by Huse v. Den, 85 Cal. 390, 24 P. 790 (1890). In Huse, the California Supreme Court denied equitable subrogation to a purchaser of land from the executor of a probate estate. The land sale was void because done without the required approval of the probate court. Subrogation was denied primarily because the purchasers had been warned not to purchase without the probate court's sanction, and knew of the executor's lack of power to sell without it. "They were not therefore, ignorant purchasers in good faith, to whom the doctrine of subrogation

would, under any circumstances apply." 24 P.2d at 791. Moreover, the Huse court noted, the purchasers' money was paid to the executor and not to the heirs, and was commingled with other estate funds. Id.

Relying on the court's allusion to "ignorant purchasers in good faith," plaintiff argues Huse stands for the proposition that constructive notice of outstanding claims defeats an encumbrancer's entitlement to equitable subrogation. Because the record chain of title contained the "suspicious" quitclaim deed from the Coxes to Marko, plaintiff contends, and because Cardinal's possession of the property could have been discerned by a reasonable inspection, Watsonville Federal should be charged with notice of adverse claims and thereby rendered ineligible for equitable subrogation.

Huse did not turn on constructive notice, but rather actual notice. Further, the more recent Katsivalis decision allows subrogation where the party invoking it is "not chargeable with culpable and inexcusable neglect." 138 Cal. Rptr. at 625. That standard is consistent with the result in Huse. The bankruptcy court reasonably found that Watsonville Federal was not chargeable with such neglect.

I affirm the Bankruptcy court's allowance to defendants of the offset reflecting satisfaction of prior encumbrances. Equitable subrogation was properly invoked.

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CONCLUSION

The bankruptcy court's ruling is affirmed in part, reversed in part, and remanded for adjustment of the judgment in accordance with this Opinion.

DATED this 2nd day of February, 1993.

MICHAEL R. HOGAN
United States District Judge

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

In re S.D. COX INVESTMENTS, INC., STEVEN D. COX, DEBORAH M. COX, and EUGENE R. RICHMOND JR., Debtors.	CV-92-6132-HO Bankruptcy Court Case Nos. 684-08450-H7 684-08496-H7 684-08497-H7 684-08498-H7
PAUL LANSDOWNE, INC., Trustee, Plaintiff-Appellant, vs. TAMARA MARKO, et al., Defendant-Appellees.	Adversary Proceeding No. 687-5025-H O R D E R

Hogan, J.:

The bankruptcy court's ruling awarding judgment to plaintiff is affirmed in part, reversed in part, and remanded for

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adjustment of the judgment in accord with the accompanying Opinion. The request for oral argument is denied.

IT IS SO ORDERED.

DATED this 2nd day of February, 1993.

MICHAEL R. HOGAN
United States District Judge

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

In re:
S.D. COX INVESTMENTS, INC.,
STEVEN D. COX, DEBORAH M. COX, and
EUGENE R. RICHMOND JR.,

Debtors.

Civil No. 92-6132-HO

Bankruptcy Nos.
684-08450-H7
684-08496-H7
684-08497-H7
684-08498-H7

PAUL LANSDOWNE, INC., Trustee
Plaintiff-Appellant,

vs

TAMARA MARKO, et al.,
Defendant-Appellees.

Adversary No. 687-5025-H

JUDGMENT

The Bankruptcy court's ruling awarding judgment to plaintiff is affirmed in part, reversed part, and remanded for adjustment of the judgment in accord with the accompanying Opinion.

Dated: February 3, 1993.

Donald M. Cinnamond, Clerk

by Lea Force
Lea Force, Deputy

DOCUMENT NO: _____